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# Who Understands Audit Reports?

By Benny R. Zachry

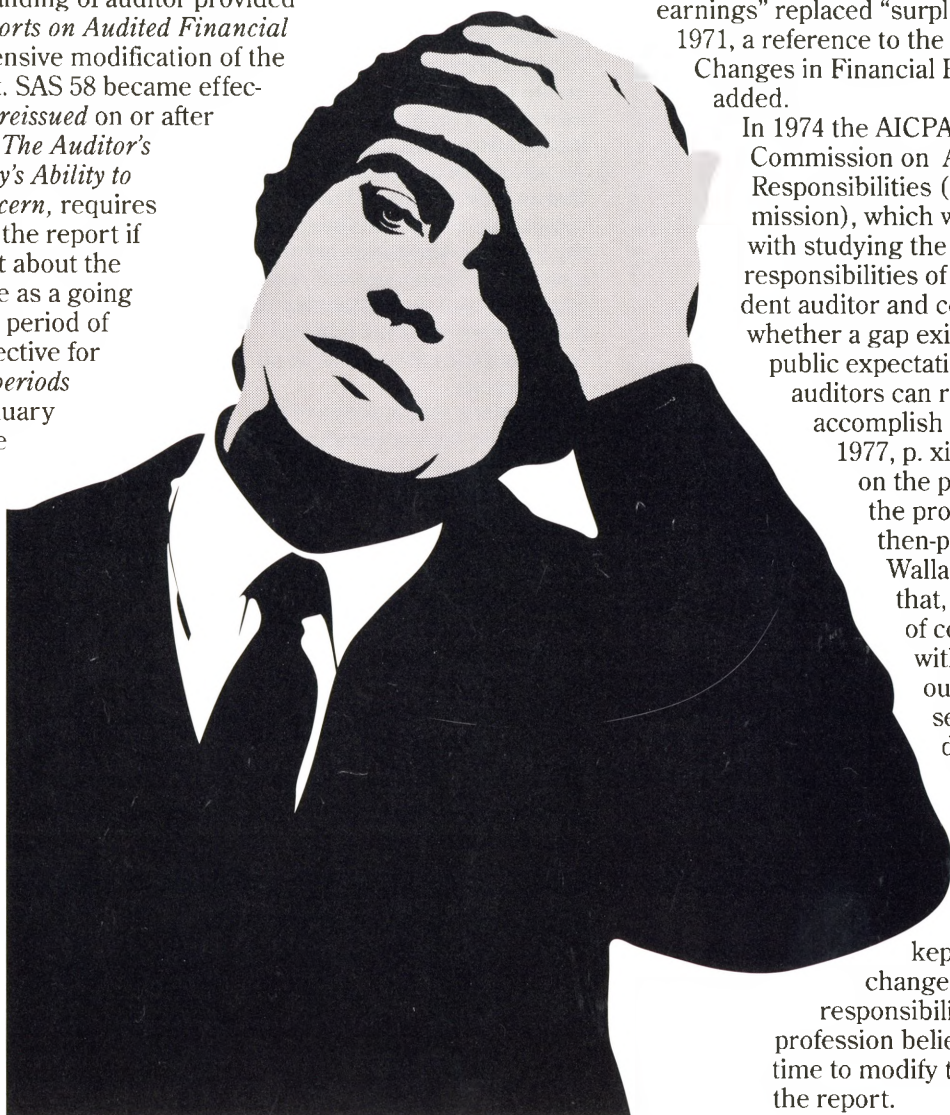
After three years of work, the Auditing Standards Board (ASB) released ten new statements on auditing standards (SASs). These "expectation gap standards" represent an attempt to close the gap that exists between public perception and expectations of the auditor's responsibility and the auditor's assessment of that responsibility.

Among the new standards are two SASs which purport to improve user understanding of auditor provided information. SAS 58, *Reports on Audited Financial Statements*, requires extensive modification of the standard auditor's report. SAS 58 became effective for reports issued or reissued on or after January 1, 1989. SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to indicate in the report if there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. SAS 59 became effective for audits of statements for periods beginning on or after January 1, 1989. Issuance of these two statements represents the first substantial change in the standard auditor's report in some forty years. After briefly reviewing the background and history of these new standards, this article will report the results of a survey of auditing practitioners and auditing faculty regarding these new standards and whether the changes in the standard auditor's report mandated by the standards will improve user understandability.

## The Standard Report, 1948-1988

Since 1948, auditor responsibility has been greatly expanded and clarified, but until now there has been no corresponding change in the nature of the standard report other than superficial changes in the wording due to changes in generally accepted accounting principles. For example, in 1963 the term "retained earnings" replaced "surplus," and, in 1971, a reference to the Statement of Changes in Financial Position was added.

In 1974 the AICPA formed the Commission on Auditor's Responsibilities (Cohen Commission), which was charged with studying the role and responsibilities of the independent auditor and considering whether a gap existed between public expectations and what auditors can reasonably accomplish [Commission, 1977, p. xi]. Commenting on the problem facing the profession, AICPA then-president Wallace Olse, said that, "our method of communicating with the users of our reports ... is seriously deficient" [AICPA News, 1975, p. 71]. Since changes in the standard report had not kept pace with changes in auditor responsibility, many in the profession believed that it was time to modify the wording in the report.



The Cohen Commission recommended in 1978 that the standard report be revised to provide better communication with users both with respect to the nature of an audit and with contents of the financial statements [AICPA, 1978]. Thus, in 1980, the ASB issued an *Exposure Draft* proposing changes in seven distinct areas of the standard report. The proposed changes were designed to improve communication between the auditor and the user.

Although the ASB rejected the changes proposed in the 1980 exposure draft, work did not cease on the project. Due to increased concern among accounting firms, judges, members of Congress, and the financial press about the quality of financial reporting and independent audits, the ASB began work on what eventually became known as the "expectation gap standards" [Official Releases, 1988, p. 144]. Added impetus to the project was given by the report of the National Commission on Fraudulent Financial Reporting, better known as the Treadway Commission. In 1987 the ASB issued ten exposure drafts, nine of which subsequently were approved in early 1988, while one was deferred. The tenth statement issued contained technical corrections of prior SASs needed as a result of the new standards.

### Scope of the Study

The new SASs represent a prelude to major changes in how auditors will perform and report on audit engagements. For the user, the wording in the standard report is the most obvious change. Since the ASB intended that the new form of the statement be a more effective communicative device and thus more understandable to users, an objective of this study was to measure the opinions that professionals involved both directly (audit practitioners) and indirectly (audit faculty) in the audit process have regarding the revisions in the audit report. Audit practitioners must work with and apply the new audit standards on a daily basis. Therefore, it is important to know how practitioners view the new standards in terms of effectiveness.

Audit faculty represent the academic group most responsible for

**Table 1**

### ATTITUDES TOWARD RECENT CHANGES IN THE AUDITOR'S STANDARD REPORT AUDIT PRACTITIONER (P) COMPARED TO AUDIT FACULTY.

Questionnaire Statement:		Responses, In Percentages			
		STRONGLY AGREE	AGREE	DISAGREE	STRONGLY DISAGREE
1. The Users of financial statements do not understand the <i>old</i> form of the standard auditor's report.	P F	21% 13	52% 50	21% 31	6% 7
2. Users of financial statements will not understand the new form of the standard auditors's report.	P F	10 4	40 39	50 46	0 10
3. Use of the term "audited" rather than "examined" in the report will be viewed by financial statement users as a more descriptive term of the audit process.	P F	6 25	68 52	21 20	4 3
4. The addition of an introductory paragraph, which differentiates management's responsibilities for the financial statements from the auditor's responsibility to express an opinion on the financial statements from the auditor's responsibility to express an opinion on the financial statements will improve user understanding of the nature of the independent audit engagement.	P* F	6 30	74 61	15 7	4 3
5. An acknowledgment in the audit report that an audit is planned to provide reasonable assurance about whether the financial statements are free of material misstatement will result in improved user understanding of the independent auditor's role and responsibility with respect to an engagement.	P F	11 11	62 66	23 22	4 1
6. Elaborations on the scope of the audit in the second paragraph will result in improved user understanding of the nature of the independent audit engagement.	P F	0 8	63 60	31 28	6 4
7. Removal of the consistency reference will not alter the financial statement users perception of the independent auditor's responsibility to evaluate changes in accounting principle.	P F	10 8	63 57	23 26	4 8
8. An explanatory paragraph in the audit report describing substantial auditor doubt about the entity's continued existence will be interpreted by users to relieve the auditor of liability in the event the entity does fail.	P F	4 4	31 19	50 58	15 18
9. <i>Absence</i> of an explanatory paragraph in the audit report describing auditor doubt about continued existence will be interpreted by users as assurance of an entity's continued existence.	P F	9 14	62 58	26 26	4 1

*\*Chi-square analysis indicated a significant difference of opinion between audit practitioners and audit faculty at the .05 alpha level. Differences for all other statements were found to be not significant at the .05 alpha level.*



forming the attitudes of future audit practitioners (current auditing students) regarding professional standards. It is important to know how the academicians view the new standards, since their opinions may influence the viewpoint to future auditors. Oftentimes practitioners and academicians disagree on major accounting and auditing issues and it is hypothesized that the new standards may represent an area of disagreement between the two groups. Thus, a secondary objective of the study was to determine whether these two groups hold similar opinions regarding the expected effects of SAS 58 and 59.

Table 1 shows the results of a survey made of audit practitioners and audit faculty regarding their views on whether the revisions to the audit report will achieve the result desired by the ASB: more effective communication and better understandability of both the report and the responsibility of the auditor.<sup>1</sup>

### Results of the Survey

It would seem from the reported results that both respondent groups agree that the individual changes made to the standard auditor's report by SAS 58 will result in improved user understandability. However, approximately half of all respondents believe that users will not understand the new form of the standard report [see results for Statement 2].

Although some distributional differences were noted in the response by each group, these differences were not significant at the alpha level of .05 except for the impact of the new introductory paragraph. The fact that both practitioners and academicians have similar opinions on these important issues is thought to be significant since oftentimes these two groups tend to disagree on major accounting issues.

Specifically, both practitioners and faculty agree that users do not understand the old form of the standard auditor's report, and many of the respondents do not believe that users will understand the new form of the report. Respondents generally agree that the addition of an introductory paragraph describing management's responsibility, along with elaborations on the scope of the

audit in the scope paragraph, will improve user understanding of the nature of the audit engagement. Likewise, respondents expect that users will better understand the auditor's role and responsibility if the report acknowledges that the audit is planned to provide reasonable assurance that the financial statements are free of material misstatements.

Respondents do not expect the deletion of the consistency phrase in the opinion paragraph to alter user perception of the auditor's responsibility to evaluate changes in accounting principle. However, one potential problem may arise because of this change. Since many users do not understand the basic conventions, assumptions, and principles already, it is feared that consistency will become relegated to an obscure status as well.

Survey respondents do not believe that addition of a "substantial doubt" paragraph in the report will be interpreted by users to relieve the auditor of liability in the event the entity does fail. However, absence of this explanatory paragraph is believed to be interpreted by users as assurance of an entity's continued existence. One respondent said that the new standards are a ... valiant attempt to educate users and to further protect the auditor from lawsuits. However, if users continue to expect guarantees ... of continued profitability, no language changes will dissuade them.

However, another respondent commented that the revised report "does not do any great harm to anyone." It will have a "relatively low incremental cost and may provide some users with additional enlightenment." If that occurs often enough, then the ASBs efforts at revising the standard report will have paid off.

Since both practitioners and faculty share doubts concerning the overall effects of the new reporting requirements mandated by SAS 58 and 59, it would seem prudent to conduct additional research on this topic. It is recommended that the ASB continue to study these issues. Since the results of this survey indicate that two of the groups so closely involved in the audit process agree on many important issues, it is believed that both groups are poised to work

together and also with the ASB to resolve any reporting problems still facing the auditing profession.

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Zachry, Benny R., and Clyde L. Posey, "The Proposed Auditor's Standard Report: A Review of CPA Attitudes," *Mid-South Business Journal*, (2nd Quarter, 1982), pp. 23-25, 27.

<sup>1</sup> To this end, a pre-tested questionnaire was mailed to an AICPA provided random sample of 150 CPAs who work as auditing practitioners. Of the 150 questionnaires mailed, 48 completed questionnaires were returned, for a response rate of 32 percent. Additionally, a copy of the same questionnaire was mailed to a sample of 150 auditing professors from colleges and universities randomly selected from the most recently available edition of Hasselback's *Accounting Faculty Directory*. Of the 150 questionnaires mailed to audit faculty, 74 completed questionnaires were returned, for a response rate of 49 percent.

Each auditing practitioner and faculty member surveyed was presented with a series of nine statements dealing with the subject material and was asked to respond to each statement based on his/her level of agreement or disagreement with each statement. The percentage response by each group to each statement is given in Table 1. The Chi-Square test of independence was used to determine whether there were significant distributional differences between the two response groups in their responses to the ten statements.